

# regulation:

## will europe's financial services action plan succeed?



By Sheenagh Gordon-Hart, head of Strategy, Research and Government Affairs, JPMorgan Investor Services, Europe, Middle East & Africa (EMEA)

Sheenagh Gordon-Hart joined JPMorgan in 2001 as head of Strategy and Research for the Investor Services Division, EMEA and has responsibility for Government Affairs. She has an MA in Political Science and Law, and is a Chartered Accountant.

**2004 saw an historic enlargement of the European Union (EU) and progress toward the final stages of the Financial Services Action Plan (FSAP). The jury is still out on both developments — their impact will be emergent rather than immediate. However, what is clear, is that the EU certainly has no lack of ambition.**

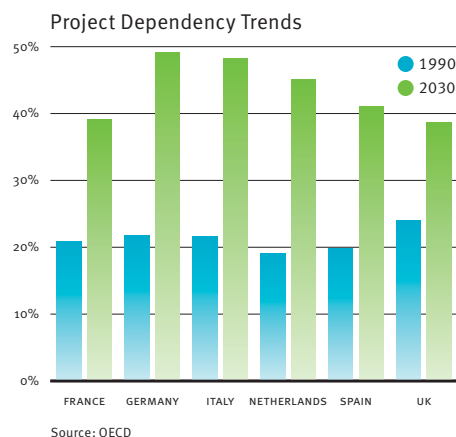
The FSAP was set out in May 1999, with the objective of achieving an integrated EU capital market by April 2004 — a lofty aim. And whilst it is in the final stages of completion, many aspects will need to be revisited as more shortcomings reveal themselves. The underlying aims of FSAP include: achieving a single financial services market, ensuring openness and security in retail markets, and providing state-of-the-art prudential rules and supervision.

Whilst the introduction of the euro was an important element in facilitating radical change by eliminating exchange rate risk, its impact on, for example, the euro-denominated bond market, was more muted than was expected. The market downturn served to bring an end to early positive signs of growth of the equity markets. Certainly a Europe-wide approach, such as that envisaged by FSAP is essential, but with 42 directives and a timetable set somewhat arbitrarily by politicians, successful outcomes are by no means guaranteed. Indeed, the FSAP is throwing into 'sharp relief' the vast differences in business practices and cultures across Europe. The problems being encountered prompted the following quote from Callum McCarthy, then the relatively new Chairman of the U.K.'s Financial Services Authority: "A series of looming bottlenecks threatens to derail the effective implementation of the EU's FSAP".<sup>1</sup>

The achievement of a single market is of critical importance for a number of reasons. The *Heinemann Report*,<sup>2</sup> commissioned by the U.K.'s Investment Management Association, for example, estimated that a single market for asset management in Europe would release €5 billion *per annum* in material

economic benefits, sufficient to increase the value of the average investor's pension by 9% or €120,000. In 2002, a study by London Economics (one of Europe's leading specialist economic consultancies) estimated that FSAP as a whole would increase Europe-wide GDP by €130 billion. As the biggest challenges facing the EU in the medium term are a rapidly aging population<sup>3</sup> twinned with a vast savings gap, achievement of a single market for asset management in the context of the broader based FSAP is vital. However, how it is to be achieved is the subject of debate and there would appear to be severe shortcomings in some aspects of the current European approach to new regulation.

For most people, Europe is acknowledged to be of great importance; however, the processes behind the scenes, and even the

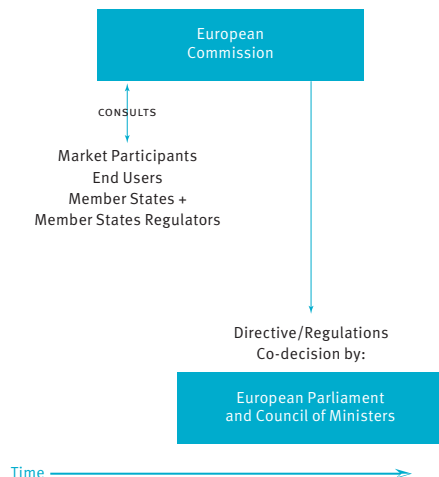


1. "Action Needed to Overcome Implementation Threat to EU Financial Reforms," October 2003.

2. Heinemann, et al, "Towards a Single European Market in Asset Management," *Zentrum für Europäische Wirtschaftsforschung*, 2003.

3. In Europe, fertility declined in the 1970s to 1.7 against a replacement rate of 2.1, while longevity increased from 67 in 1960 to 75 in 2000.

## Level 1 Proposal



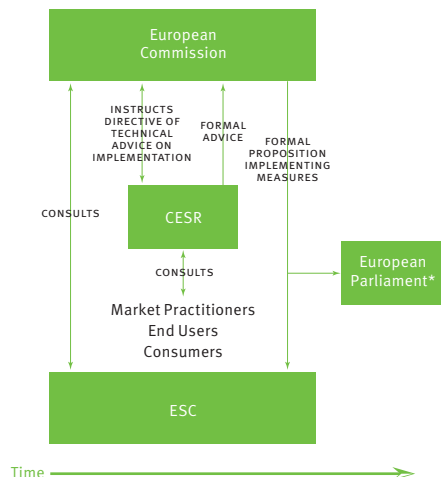
‘actors on the stage’ are not necessarily well understood. The chart below shows the road map for Levels 1 and 2 of the Lamfalussy process which Europe’s financial services market place is subject to.

This process is a four-level approach proposed initially by the “Committee of Wise Men,” (chaired by Baron Alexandre Lamfalussy) in February 2001 and designed to address some of the perceived shortcomings in European securities regulation. Whilst it has immense logic, and there has been some measurable achievement, it is by no means obvious that this is other than a step towards a more integrated approach. There are serious question marks on the enforcement front and there is some evidence that new regulation aimed at ‘harmonisation’ actually ends up promoting both greater protectionism and the creation of more imaginatively constructed barriers. Certainly, Lamfalussy has set out a framework, but the demands being placed on market participants, regulators and other interested parties by the EU’s ambitious plans are burdensome and increasingly costly.

JPMorgan, in common with other large financial institutions in Europe and around the world, has a heavy regulatory agenda. Every aspect of the FSAP affects the firm

## Level 2 Proposal

Technical Implementing Measures of  
Level 1 Directives/Regulators



\* European Parliament is given one month to consider if Level 2 measures approved by ESC should be adopted by the Commission

and its clients either directly or indirectly. Not all regulation is good regulation and we in JPMorgan Investor Services aim to play a full part in identifying threats and opportunities that present themselves with the ever burgeoning rule books.

## Taxation of Savings Directive

Another regulatory area that we have focused on over the past year is the EU Taxation of Savings Directive (EUSD). Its history has been unfolding over many years, but at its root it aims to curb opportunities for tax evasion by individuals who invest in savings accounts, securities and funds in jurisdictions other than where they reside. Evasion is a major problem in many parts of Europe and usually reflects a thriving “black economy” (the informal or unofficial economy of a country which includes undeclared earnings and enjoyment of undervalued goods and services designed for tax evasion purposes), twinned with high personal tax rates. For example, the black economies of Greece and Italy are estimated to be in excess of 25% of GDP. Whereas in the U.S., the black economy is estimated at only 8% of GDP.

The problem of evasion in Europe is widespread; German citizens are estimated to have in excess of €300 billion invested ‘offshore’, whilst the equivalent figure for

Italians is €200 billion. Benchmarking undeclared investments and other holdings is fraught with difficulty, but Switzerland alone (and it is by no means the only ‘safe haven’ for privacy) has €1.2 trillion in bank accounts held by non-residents.

So, the EUSD was introduced with a view toward eliminating opportunities for tax fraud. The concept seems simple enough and implementation would have been more straightforward if Europe existed in its own vacuum. However, the problems associated with this Directive largely stem from extraneous factors.

Probably, the most important issue that has hindered the introduction of the Directive, and certainly has been the cause of delay in implementation,<sup>4</sup> concerns the position of third countries, notably Switzerland, that pose a significant competitive threat. Switzerland had to be persuaded to sign up, at least in part, for the Directive by way of bi-lateral Treaty to enable the Directive of having any hope of succeeding inside the EU. Switzerland has now declared that it will be ready to adopt similar provisions to those established under EUSD on July 1, 2005 and hence there is unlikely to be any further delay.

Of course, the third countries required to sign up for the Directive do not comprise an exhaustive list. This in itself is a weakness. In the main, the third countries are those with close geographic or other ties to Europe or its member states, for example British dependencies. However, geography may not be a strong point at the EU — they omitted to include Bermuda, perhaps not realising that it is not in the Caribbean.

It may be worth explaining, albeit briefly, what the Directive covers. In essence, the Directive is aimed at EU cross-border payments of interest to individuals. Thus, in the first instance, there is a requirement to define what interest is — and there are instruments that it would appear should

4. Originally, the Directive was due to be implemented on January 1, 2005. It is currently expected to be implemented on July 1, 2005.

## Lamfalussy: A Four-Level Approach

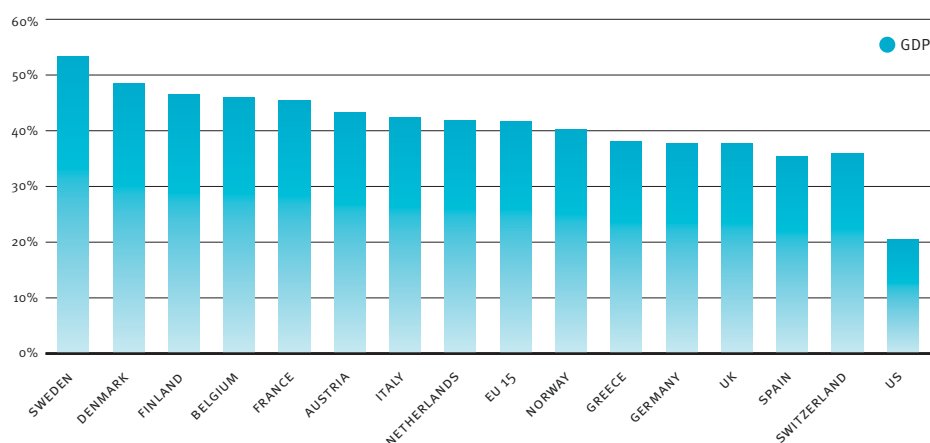
- ▶ **Level 1:** High level objectives that legislation must achieve
- ▶ **Level 2:** Defines the technical requirements necessary to achieve objectives
- ▶ **Level 3:** Provides for common and uniform implementation by, for example, providing common interpretation and guidance
- ▶ **Level 4:** Relates to enforcement

be included but that are excluded under grandfathering provisions. In addition, it seems that Switzerland for its part in signing up to EUSD has excluded income from Swiss bonds, amongst other things.

Other areas where there remain uncertainties include the treatment of funds of funds. There is intense lobbying in Luxembourg to have funds of funds excluded, but this would create a massive loophole and surely undermine the entire EUSD project. This and many other differences in interpretation have added to the frustration and cost of those institutions like JPMorgan that seek to provide scaleable pan-European solutions to clients.

**Tax Burden Chart**

Tax burden as a percentage of GDP in the USA and Europe, 1999



Source: OECD

The EUSD seeks to place responsibility for withholding tax or exchanging of information on the paying agent (defined as 'final economic operator'). This is proving to be less than satisfactory and will doubtlessly give rise to problems once the Directive is implemented, because the 'paying agent' is not the paying agent as normally understood. It has certainly required all fund groups to audit and categorise their product and client bases to establish whether the EUSD has application, overhaul KYC procedures, amend application forms, etc.

In essence, Europe will operate two parallel approaches to EUSD. The first is exchange of information, the approach finally adopted by all EU member states except Belgium, Austria and Luxembourg. In the case of the latter three states, withholding tax will be 'the norm' unless investors opt for information exchange or supply a certificate from the tax authorities in their own jurisdiction that certifies they may receive income gross. The reason given for the adoption of a different approach was explained as follows: 'In view of structural

differences, Austria, Belgium and Luxembourg cannot apply the automatic exchange of information at the same time as the other member states.' It is intended that the withholding regime should have a limited life but it is generally agreed that unless Switzerland and Luxembourg together agree to abandon bank secrecy, the régime will have an indefinite life. EUSD certainly has laudable aims — it remains to be seen if it can be hailed a success in the end. One of the U.K.'s commonly voiced criticisms of the EU's legislative and regulatory agenda is that new initiatives are not subject to cost benefit analysis — imposing such a discipline on the EUSD may not have derailed the Directive completely, but it may

have led to better-drafted legislation with a better chance of success.

### More Regulations in 2005

What else is in the European regulatory pipeline for 2005 and beyond? There are some major projects in production: Basel II (under the auspices of capital adequacy in Europe); International Accounting Standards (IAS); and Investment Services Directive reform (ISD2) under the new title of the Markets in Financial Instruments Directive, to name just three.

Basel II, drafted by and aimed at bankers, has a much broader application in Europe, with investment firms also covered along with securities dealers and others in the Risk-Based Capital Directive (CAD II). Much remains to be discussed in the fine-tuning of CAD II to European requirements — almost certainly there will be difficulties in implementation and opportunities for regulatory arbitrage will emerge. Meanwhile, the Committee of European Banking Supervisors (CEBS) has set up a consultative panel of representa-

tives of market participants and end-users to support its work on implementation of the revised capital adequacy rules.

IAS is a key area where the ambition is commendable but the growing pains may last for some considerable time. From 1 January 2005, more than 7,000 listed companies will adopt the standards. The aim — to achieve more transparency and comparability for investors and hence promote efficiency in the capital markets — is to be welcomed, but as with all big picture efforts, political obstacles have abounded, compromises and carve-outs made (on IAS 39 — treatment of derivatives); convergence with U.S. GAAP, whilst desirable, will not be achieved in this step. The impact of IAS will be much more significant for countries such as France and Germany for example, than for the U.K. and Ireland. The intention remains to reduce the requirement for reconciliation of accounts between FASB and IASB standards by 2007. Whether this will be achievable is debatable because there is significant strain between what is perceived to be the prescriptive rules-based approach adopted by the English speaking world, particularly in the U.K. and U.S., and the more principles-based approach favoured by Continental Europeans. All in all, however, International Accounting Standards, adopted in full by around 70 countries outside the EU, and in part by the EU, will be a major achievement.

The ISD II has led to significant differences of opinion, particularly concerning pre-trade transparency and best execution. Regulators hope to provide their implementation guidance in early 2005, but it is not at all clear that the outcome will be satisfactory.

Further, work continues to clarify and provide implementation guidelines under UCITS III. Many groups are concerned that UCITS III may prove to be a backward step rather than a long-awaited leap forward. The jury is out, but expect UCITS III to be the centre of some heated debate during 2005.

The question remains... How much closer is Europe getting to a single market? On 6 December 2004, CESR<sup>5</sup> hosted a conference in Paris entitled 'Europe's Single Market: Under construction or fully integrated?' The answer could be... 'trying hard, could do much better'. ○○○

5. Committee of European Securities Regulators.